79-232

No. 78-..............

IN THE

Supreme Court of the United States

OCTOBER TERM, 1978

GENERAL TELEPHONE COMPANY OF CALIFORNIA, A CALIFORNIA CORPORATION,
Petitioner,

vs.

PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, ET. AL.,
Respondents.

CITY OF LOS ANGELES, CITY OF SAN DIEGO, CITY AND COUNTY OF SAN FRANCISCO, TOWARD UTILITY RATE NORMALIZATION,
Intervenors.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

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Petitioner, General Telephone Company of California ("General"), respectfully petitions this Court for a writ of certiorari to review the decision of the United States Court of Appeals for the Ninth Circuit entered on July 18, 1979, upholding the district court's denial of a preliminary injunction in this action on the ground that such relief was barred by the res judicata effect of the California Supreme Court's denial of a writ of certiorari to review an order of the Public Utilities Commission of the State of California.

INTRODUCTORY STATEMENT

This action is a companion case with *Pacific Telephone and Telegraph Co.* v. *The California Public Utilities Com-*

mission, et al., No. 78-............ and was consolidated with that case in the court below for purposes of appeal. On August 1, 1979, both General and The Pacific Telephone and Telegraph Company ("Pacific") filed applications for a temporary stay of the court of appeals decisions in Case Nos. 79-3150 and 79-3151. (Case Nos. a101 and a102). On August 6, 1979, Justice Rehnquist ordered those decisions stayed until further responses were received and until further order of the Circuit Justice. Pacific filed its Petition for Writ of Certiorari on August 10, 1979. General joins in and hereby adopts and incorporates the Petition filed by Pacific. The opinions below, the jurisdictional basis, the questions presented and the Constitutional and statutory provisions involved are identical in this case to those presented in Pacific's Petition. Pacific's statement of the facts and reasons for review apply with equal force to General's Petition. To avoid burdening the Court, General does not repeat those statements here. Pacific does offer, however, the following statements to aid the Court in considering the questions presented.

STATEMENT OF THE CASE

As a result of continuing audits and waiver of the statute, General's federal tax returns are open back to the year 1970. During that entire period, General has filed its returns claiming the benefits of accelerated depreciation and investment tax credit under Internal Revenue Code Sections 167(l) and 46(f). Since 1970, General's rates have been collected subject to refund, but in a manner that clearly preserves General's eligibility to claim accelerated depreciation and investment tax credit under the applicable code provisions and Treasury Regulations. The rates were collected subject to refund while the California Public Utilities Commission (the "Commission") determined how it would treat, for rate setting purposes, General's tax expense in the face of the benefits it received from accelerated depreciation and investment tax credit. The Commission's attempts to determine this question, in addition to other questions, have resulted in a number of hearings before the Commission and reviews by the California Supreme Court.

See, City of Los Angeles v. *Public Utilities Commission*, 15 Cal.3d 680, 542 P.2d 137 (1975).

In September 1977, the Commission issued its Decision 87838 (the "Decision") setting a final rate and ordering refunds in excess of $65,000,000 for the years 1970 through 1977 and lower rates in the amount of $13,000,000 per year for the years 1978 and thereafter. (Findings of Fact No. 6, Jt. App. at 18a).* These refunds and lower rates resulted from an attempt by the Commission to "flowthrough" to the ratepayers more of the tax benefits General has received from accelerated depreciation and the investment tax credit than the IRS says is permissible under the statutes and applicable regulations. The IRS has ruled that the consequence of these refunds and lower rates will be a loss of eligibility to claim accelerated depreciation and investment tax credit for all open tax years. (Findings of Fact No. 10, Jt. App. at 19a). In the case of General, this will result in a tax deficiency currently in excess of $300 million. In the case of Pacific and General combined, the tax deficiency will be in excess of a billion dollars. (Findings of Fact No. 8, Jt. App. at 19a).

The Commission recognized that such a loss of eligibility would create a "myriad" of problems, have severe financial effects upon the utilities and result in a deterioration of service. (Decision; Jt. App. at 91a-92a). Indeed, the Commission expressly found that the preservation of eligibility for these tax benefits was a goal of its Decision. (Decision; Jt. App. at 117a). It concluded, however, that eligibility would not be lost because of the refunds and lower rates which it ordered and predicated its final rate order on this assumption. (Decision; Jt. App. at 119a-20a; Findings of Fact No. 7, Jt. App. at 19a). The IRS continues to disagree with the Commission's conclusion and has issued a Revenue Ruling that, if the Decision goes into effect, it will assess the tax deficiencies for all open tax years. (Findings of Fact No. 10; Jt. App. at 19a).

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* For the convenience of the Court, General has filed a Joint Appendix with Pacific in Case No. 78-........................ References to that Appendix are cited as Jt. App.

The California Supreme Court denied a writ to review the Decision (equivalent to writ of certiorari) and an application to this Court for a writ of certiorari to review the California Supreme Court's denial was also denied. .... U.S. ...., 99 S.Ct. 733, 734 (Nos. 78-606 and 76-607, Dec. 11, 1978). On the day after the Commission ordered that the Decision go into effect, these actions were commenced in the district court and the Decision has since been stayed by temporary restraining order and temporary injunction.

The nub of the questions presented in this action is that the utilities are caught in a conflict between two sovereigns — the Commission and the IRS — as to what the tax law *ought to be* and *is.* Both sovereigns are proceeding against the utilities on the basis of conflicting assumptions as to what the law is. No court with jurisdiction to decide the question and to bind the two sovereigns has yet had an opportunity to decide the tax questions. Both General and Pacific asked the Commission to stay the effectiveness of its Decision until the tax questions could be resolved, but that request was denied. (Pub.Ut.Comm'n Dec. 90094, Mar. 14, 1979, Jt. App. at 67a). Until the Decision became final, no review of the tax questions was available in the federal court system. This action was filed in an attempt to have the tax questions resolved in the federal courts which have jurisdiction to bind both the IRS and the Commission.

Meanwhile, the Commission's Decision, based on the Commission's view of what the tax law ought to be, is about to go into effect and conclusively bind the utilities to that interpretation of the law. The IRS, however, will not be so bound. As a consequence, the utilities will be irreparably harmed on three levels:

(1) In the absence of a preliminary injunction, General will be denied a forum in which both the IRS and the Commission can be bound to a consistent interpretation of the federal tax laws without irreparable harm to General.

(2) In the absence of a preliminary injunction, General faces the risk of double liability as a result of inconsistent orders of two sovereigns. Once the Decision goes into

effect, General's rates for the years 1970 and forward will become final. Under California rate-making law, rates in future years cannot be increased to make up for improperly low rates in the past. Pub.Util.Code §§ 728, 734; *City of Los Angeles* v. *Public Utilities Commission*, 7 Cal. 3d 331, 356-57; 497 P.2d 785, 803-04 (1972); *The Pacific Telephone & Telegraph Co.* v. *Public Utilities Commission*, 62 Cal. 2d 634, 649-56; 401 P.2d 353, 362-66 (1965). (Findings of Fact No. 9, Jt. App. 19a). Thus, once the rate refunds and reductions are made, the mold will be set from which General's eligibility for the tax benefits must be determined. If the federal courts eventually conclude that the IRS is correct in its interpretation of the tax law and that the Commission is wrong, General will be in the position of having to pay huge tax deficiencies while having no way to recoup the refunds paid to the ratepayers as tax benefits that proved to be illusory.

(3) In the absence of a preliminary injunction, General faces the risk that it will be denied, without opportunity for judicial review, a fair return on assets used for public services, but held as a tax reserve that has been excluded from the rate base in setting its rates.

The only relief General seeks in this action is to have the Decision enjoined from going into effect until the tax questions can be resolved by a forum that has jurisdiction to bind both the Commission and the IRS. Once the tax questions have been decided, the Commission can correct its order, if necessary, or the district court can decide the legal consequence of inconsistent orders and protect the utilities.

The relief sought in this action would result in no harm to the Commission or to General's ratepayers. As noted, General's rates are presently being collected subject to refund. Those refunds, if ever required, will be made with accrued interest. (Findings of Fact No. 8, Jt. App. at 19a). Indeed, the Commission has never argued that delaying the effectiveness of its Decision would result in any harm to it or General's ratepayers. Conversely, the Commission did conclude that harm would result from a loss of eligibility

and the district court found that "General and Pacific have each met the requirements for the issuance of injunctive relief," (Conclusion of Law No. 5, Jt. App. at 20a) and that "Pacific and General would each suffer irreparable injury if their compliance with Decision No. 87838 were to cause them to lose their eligibility for accelerated depreciation and investment tax credit on their Federal Income Tax Returns." (Findings of Fact No. 13, Jt. App. at 20a). These findings were not overturned by the court below.

REASONS FOR GRANTING THE WRIT

I. Giving Res Judicata Effect to the State Court Order Denies General Due Process by Exposing it to the Risk of Double Liability to the Claims of Competing Sovereigns Without a Forum to Resolve the Conflict.

General seeks to have this Court decide whether, in the unique factual and procedural setting of this case, it has been denied due process by the lack of a forum with jurisdiction to resolve a conflict between the Commission and the IRS as to a correct interpretation of the federal tax laws. The conflict between the Commission and the IRS in effect results in a claim by each of the sovereigns to the same funds. The Commission has found that the ratepayers are entitled to refunds of the tax benefits. The IRS has ruled that, if the refunds are made, these same tax benefits will be lost, with the result that the tax reserves and credits, a portion of which the Commission has ordered must be refunded irretrievably to ratepayers, must be paid to the United States as tax deficiencies.

In *Western Union Telegraph Co.* v. *Pennsylvania,* 368 U.S. 71 (1961), the Court held, in a similar dispute between sovereigns over funds held by Western Union, that a state order to relinquish the funds resulted in a denial of due process because the state court lacked jurisdiction to bind other sovereigns. In that case, Pennsylvania, acting under the state law, obtained an escheat order with respect to unclaimed wire transfer funds held by Western Union. New York had already seized and escheated a part of the very funds that were claimed by Pennsylvania. Western

Union was thus exposed to a risk of liability, flowing from the Pennsylvania court's action, to a party over whom the Pennsylvania court had no jurisdiction and who could, therefore, not be joined as a party. This Court stated:

"[T]he holder of . . . property is deprived of due process of law if he is compelled to relinquish it without assurance that he will not be held liable again in another jurisdiction or in a suit brought by a claimant who is not bound by the first judgment." 368 U.S. at 75.

General is in the same position as Western Union. The Commission has ordered it to relinquish property that General is holding as a reserve for deferred taxes. Once General relinquishes this property as refunds, it will be subject to liability to the IRS, not only for the amounts paid out as refunds, but for the entire amounts held as credits and as a reserve for deferred taxes. Ironically, this is the very result which the Commission has stated as its goal to avoid.

Irreparable harm flows from this risk of double liability since once the refunds have been made they can never be recouped. Furthermore, the act of making the refund triggers tax liability resulting in tax expense far in excess of the estimated tax expense upon which General's rates were set. Future rates, however, cannot correct for either the refund or the increased tax expense.

This Court has consistently held that there is a denial of due process where a party is subject to a risk of double liability without a forum in which all interested parties can be bound. In *California* v. *Texas,* 437 U.S. 601, 608 n.10 & 611 (1978), this Court recognized the continued validity of the *Western Union* principle in a case involving a risk of double liability for death taxes. Similarly, in *United States* v. *First National City Bank,* 379 U.S. 378, 384 (1965), the Court suggested that if court action freezing a bank's foreign accounts would expose it to "double liability" there would be a denial of due process. The relief granted in that case is analogous to the relief sought here. The United States sought to recover for tax liability against a foreign corporation by freezing the foreign corporation's account

in First National City Bank. The district court froze the account, even though it was in a foreign branch. This Court affirmed, holding that this relief was proper to preserve the status quo pending service of process on the foreign corporation and an adjudication on the merits. 379 U.S. at 385. This is the exact relief General seeks here — to preserve the status quo pending a determination of the merits of the tax and Constitutional questions.

The court of appeals rejected this relief, relying upon *Napa Valley Electric Co.* v. *Railroad Commission*, 251 U.S. 366 (1920) and concluding that the Constitutional questions were frivolous (Jt. App. at 5a n.6). The court further concluded that the question at issue was not a construction of a federal statute, but rather the scope of the Commission's discretion in setting rates. *Id.* The court below erred in the following respects:

(1) A state court judgment has res judicata effect only if the state court had jurisdiction to decide the issues presented to it. *Montana* v. *United States*, ... U.S. ....; 99 S. Ct. 970, 973 (1979). In *Napa Valley*, the state court had the power to decide not only the rate-setting questions, but also the federal Constitutional issues. Indeed, in most settings, the state court is competent to decide federal Constitutional issues as well as federal statutory issues. In the present action, however, the state court lacked jurisdiction because it could not conclusively bind the IRS to its interpretation of the federal tax law. By giving res judicata effect to the state court order, the court below denied General a forum in which the federal tax questions can meaningfully be decided without the exposure to double liability. *Napa Valley* did not involve a risk of double liability nor deny the utility a forum that had jurisdiction to decide the federal issues at a meaningful point in time.

(2) In the context of this factual and procedural setting, the Commission's determination of federal tax questions, which was beyond the scope of its discretion in setting rates, denied General due process. The federal tax statutes and regulations are clear in describing the

accounting method required of a utility to qualify for accelerated depreciation and the investment tax credit. General does not contest that it is within the scope of the Commission's discretion to determine what a utility's tax expense will be under those statutes and regulations and the Commission has demonstrated its ability to interpret those regulations so as to comply with the federal tax law. Since 1970, General's rates have been collected under an interim order, subject to refund, which clearly preserves eligibility. The present problem arises, not because of the Commission's inability to interpret the federal statutes and regulations and to set General's tax expense, but because of the Commission's disagreement with Congress and the IRS as to what the tax policy *ought to be.* Any doubt that the Commission was *determining* tax policy rather than *interpreting* the tax laws is put to rest by a comparison of statements of the two sovereigns:

Commission

"We desire to discuss the wisdom of using the tax laws for the purpose of providing a capital subsidy (in this instance, phantom taxes) from the taxpayers (in this instance, the ratepayers) to a special interest group (in this instance, state-regulated utilities) . . . . The funds are being obtained from the ratepayers under the guise of taxes, while Congress has decreed that the money so collected as taxes need not be used as taxes by the utilities, but may be used by the utilities for whatever purposes they desire . . . . Congress has created a situation where in California both the utilities and the ratepayers feel they are being whipsawed by these tax laws and the actions of this Commission in attempting to be fair to all sides. This Commission believes that it has a legal duty to balance the interests of the utilities and the ratepayers and is attempting to do so, but finds itself more frequently hamstrung by the actions of Congress where it appears that the interests of the utility ratepayers are not adequately considered, for whatever reason." (Decision, Jt. App. at 113a-14a).

Congress

"The House bill provides that in the case of certain listed regulated industries a taxpayer is not permitted to use accelerated depreciation unless it 'normalizes' the current income tax reduction resulting from the use of such accelerated depreciation. (Normalization involves the utility retaining the current tax reduction and using this money in lieu of capital that would otherwise have to be obtained from equity investments or borrowing.)" Conference Report No. 91-782. 1969-2 U.S. Code Cong. & Ad. News 2427.

"*Reasons for provisions.*— In restoring the investment credit, your committee concluded that it was appropriate to increase somewhat the credit previously available for regulated companies. As indicated above, the prior law's rate for most public utility property was 3 percent. Your committee's bill raises the rate for public utility property to 4 percent. In part, this is provided because of the increasing problem many utilities are encountering in raising the capital required for modernization and expansion." House Report No. 92-533, 1971-2 U.S. Code Cong. & Ad. News 1839.

Under the guise of "interpreting" the federal statute, the Commission has used an accounting method to calculate General's rates that passes on to the ratepayers a greater portion of the tax benefits than is provided under the tax law. Thus, the Commission exceeded its discretion to determine tax expense and determined federal tax policy. Similarly, it was beyond the jurisdiction of the California Supreme Court to determine federal tax policy. The Congress has the power under the Constitution to determine tax policy and the IRS has the statutory authority to interpret by regulation those statutes. *See* Internal Rev.Code § 7805. Questions as to uncertainties in the federal tax statutes and regulations are within the original jurisdiction of the federal courts. 28 U.S.C. § 1331. The state courts have no jurisdiction to determine federal tax policy since they have no power to bind the taxing authority — the IRS. The Commission's attempt to do so in the present case emphasizes the reason state courts have no jurisdiction — their interpretations as to federal tax law can have no effect other than to create the risk of double liability.

(3) Finally, the court below erred in concluding that General had had its day in court (Jt. App. at 15a n.15). While General has presented its claims to the Commission, the Commission never had jurisdiction or competence to bind the IRS and thus avoid creating the risk of double liability. Similarly, the California Supreme Court had no jurisdiction to bind the IRS. The opportunity for a writ of certiorari to this Court also did not provide a forum in which the IRS could be joined. While it is true that General may have an opportunity to litigate the tax questions in some subsequent federal court, absent the relief sought here, that litigation cannot avoid the risk of double liability; the refunds will have been irretrievably made. Indeed, absent the relief requested here, General will be in the position of having to argue before some subsequent court that the tax laws should be exactly the opposite of what it has consistently argued they are. In the setting of this case, the possibility of such subsequent federal review of the tax question is not an opportunity for a meaningful hearing.

II. Giving Res Judicata Effect to the State Court Order Exposes General to the Risk that its Property will be Confiscated Without Judicial Review or Fair Compensation.

The denial of a preliminary injunction exposes General to the risk that hundreds of millions of dollars of investment in telephone plant will have been placed in public service without General having earned a fair rate of return on that amount. Under the applicable tax statutes and regulations, tax savings accruing from accelerated depreciation must be set aside in a tax reserve. Treas. Reg. § 1.167(l)-1(h)(2). As contemplated by Congress in passing the tax legislation, General has used this tax reserve to purchase additional plant and equipment that have been used for public service. *See* Conference Report No. 91-782, 1969-2 U.S. Code Cong. & Ad. News 2427; House Report No. 92-533, 1971-2 U.S. Code Cong. & Ad. News 1839. Under the tax laws, however, this tax reserve may be and has been excluded from the rate base. *See* Treas. Reg. § 1.167(l)-1(h)(6). Thus, while General has placed hundreds of millions of dollars of plant and equipment in public service, it has not earned any return on those assets. If eligibility for accelerated depreciation is preserved, this fact does not work a hardship upon General since it is able to replace and add to its plant and equipment while ratepayers benefit from the lower rates flowing from lower tax expense. If eligibility is lost and a tax deficiency is assessed, however, General will be required, in effect, to replace this tax reserve with shareholders' capital. Thus, during the entire period that its tax years are open, General and its shareholders will have been denied a return on assets placed in public service.

Both the California and federal courts have recognized that forcing a utility to place in public service assets without a fair rate of return is confiscatory and a denial of due process. E.g., *Bluefield Water Works & Improvement Co.* v. *Public Service Commission*, 262 U.S. 679, 690 (1923); *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944); *The Pacific Telephone & Telegraph Co.* v. *Public Utilities Commission*, 62 Cal.2d 634, 647; 401 P.2d 353, 360-61 (1965). The district court's denial of a

preliminary injunction subjects General to this risk. Furthermore, in the absence of a preliminary injunction, there is no forum in which the question of whether such a result is a denial of due process can be litigated.

The Commission avoided the issue by assuming that eligibility would not be lost. Similarly, the California Supreme Court's denial of a writ of certiorari at most affirmed the Commission's assumption that eligibility would not be lost and the confiscatory nature of the Commission's order and the denial of due process were never considered. Furthermore, until the tax question is resolved, the due process question is nonjusticiable since one must speculate as to the outcome of the tax litigation. By the time the tax question is resolved, rules against retroactive rate-making will preclude any effective remedy. This question can be decided only by preserving the status quo until the tax questions can be resolved. If in fact the Commission's interpretation of the tax statutes is incorrect, the district court can then determine whether the Decision would result in a confiscatory taking of General's property.

III. The Special Circumstances and Unfairness of General's Plight Preclude the State Court Order from Having Res Judicata Effect.

In *Montana* v. *United States*, ... U.S. ....; 99 S. Ct. 970 (1979), this Court recently recognized at least three situations in which a state court judgment does not bar further litigation in federal court:

(1) The "right, question or fact [has not been] distinctly put in issue and directly determined by a court of competent jurisdiction . . . ." .... U.S. at ....; 99 S. Ct. at 973.

(2) A party who is "compelled, without his consent . . ., to accept a state court's determination of [federal] claims . . .' " may not be barred from having the "federal courts make factual determinations essential to the resolution of federal questions." .... U.S. at ...., 99 S. Ct. at 979.

(3) "Redetermination of issues is warranted if there is reason to doubt the quality, extensiveness, or unfairness of the procedures followed in the prior litigation". .... U.S. at n.11; 99 S. Ct. 979, n.11.

The Commission's Decision must fall by the wayside under each of these exceptions. As discussed above, the Commission was without competent jurisdiction to bind the IRS to an interpretation of federal tax law. Similarly, General was compelled, without its consent, to litigate the federal tax questions, both factual and legal, before the Commission, rather than in the federal courts. General was precluded from raising the tax question in the federal courts until the Commission finally decided the accounting method it would require General to adopt. Finally, the Commission's procedure for determining the federal tax issues must be questioned since the taxing authority — the IRS — could not be made a party, could not present its views and could not be bound by the final outcome. Because of these failings, General was placed in a position of substantial unfairness because of its exposure to double liability and the risk of a loss of return on shareholder capital it may be required to place in public service.

The court of appeals and district court below failed to consider these inequities in giving the Decision res judicata effect and thus committed error causing substantial prejudice to General.

CONCLUSION

For the reasons stated above and in Pacific's Petition, General respectfully submits that certiorari should be granted.

Respectfully submitted,

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79

231